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SIPDIS

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STATE EEB/TPP/ABT/ATP JANET SPECK
AG FOR FAS CHRIS RIKER
NEW DELHI PASS TO FAS

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SUBJECT: RESPONSE: IMPACT OF RISING FOOD PRICES - SRI LANKA

REF: A. SECSTATE 39410

1B. COLOMBO 370

11. (SBU) SUMMARY: The impact of rising food prices is affecting all households in Sri Lanka. Recent jumps in prices of rice and other food commodities have come on top of 20% domestic inflation rates. In the past year, food commodity prices are up 50-100%, and the trend is continuing. On average, food prices now account for 47 percent of total consumer expenditure, with poorer households spending more than 80 percent of their total income on food commodities. Nutrition levels are declining; only an estimated half of the country's 20 million people consume the recommended minimum daily caloric intake. The government's erratic policies in the agriculture sector and corruption have contributed to the poor performance of domestic agriculture. End summary.

12. (U) Information in this cable is keyed to questions raised in Ref 1A.

Demand

13. (U) Rice is the most important agricultural commodity consumed in Sri Lanka. Annually, 95-105 kilos of rice are consumed per person. Wheat is also important to the Sri Lankan diet, at approximately 40 kilos per capita consumed yearly. Statistics of cereal consumption over the past five decades reveal an increase in wheat consumption and a reduction in per capita consumption of rice. The country's entire wheat requirements are met by imports; no wheat is grown locally. Wheat imports for 2007 were 850,000 tons. The majority of the rice requirement is locally produced, with shortfalls bridged through imports. 2007 rice imports were 70,000 tons. However, torrential rains affected the recently concluded major harvest, and imports needed to meet demand in 2008 are estimated at 300,000 tons (Ref B).

14. (U) There has been no shift towards alternate commodities because (a) rice and wheat are the staple diet of the average Sri Lankan, and (b) the cost of meat, fish and even vegetables are beyond the reach of the average consumer as a substitute for rice and wheat. The Central Bank reports that, although rising food prices deteriorate everyone's purchasing power, some segments of the population are hit especially hard. The current high prices are especially hard on the urban poor and fixed income earners employed predominantly in manufacturing and services.

Supply

15. (U) There is no indication that domestic agriculture production is responding to increases in prices. Neither domestic nor foreign investments in food production have increased. There has been no marked increase or decrease in land usage for agriculture production except for a marginal increase in the amount of rice paddy planted. Although there is considerable unutilized and under-utilized arable land, archaic legislation and government bureaucracy inhibit the productive use of these lands.

16. (U) High input costs in the local agricultural sector are a major factor impacting food prices. Increasing labor, fertilizer, feed, and energy costs have all affected the agricultural and livestock sectors. Poultry farmers are particularly affected by high feed prices. Shortages of food storage and processing facilities, in addition to poor weather (Ref B) and hoarding, are also partly to blame for local shortages in Sri Lanka between January and April 2008. The local World Bank Country Director recently stated that growth of the high-value agricultural sector is hampered by limited market infrastructure, technology innovation, cold chains, and market information. Government intervention in agricultural marketing, which is common in Sri Lanka and which increases when supplies are disrupted, also does not allow market forces to determine supply and demand.

17. (U) Even if local production enhanced supply, Dr. Nimal Sanderatne, an eminent agriculture economist, says there is no mechanism in place for the market to absorb increased production beyond normal levels. Sanderatne states that appropriate marketing infrastructure is needed in order to accommodate the expanded production needed for demand and supply to balance.

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18. (U) There is no local production of commodities for non-food use (fuels, etc.). There is growing use of agricultural waste, such as rice husks and coconut shells, for small scale biofuel and other non-food applications.

Political Impact

19. (U) There have been no public protests or violence as a result of rising food costs. There is no immediate effect on the stability of the government as the country lacks a vibrant opposition to confront the government on critical issues. Although there have been numerous newspaper articles and general concern by citizens about rice prices and because rice is not always immediately available in some stores, the average consumer is largely a passive casualty of economic adversity. Nevertheless, if high food prices extend indefinitely and shortages occur, there could be political ramifications for the government. The government is partly responsible for high inflation due to heavy deficit spending, losses generated by public corporations, high defense expenditure, and unsustainable subsidies.

Economic Impact

110. (U) Sri Lanka's 24% inflation is driven in part by increases in international food commodity prices. According to the 2007 Central Bank annual report, the share of food items in the official inflation index was approximately 48 percent in January 2008. Imports of most key agricultural commodities increased in 2007 -- in value terms -- over the previous year's levels. These are, for the most part, taxable items that contribute to the government's import tariff revenue, which recorded an increase in 2007. Additionally, the overall budget deficit narrowed to 7.7 percent of GDP in 2007 from 8 percent the previous year, which suggests there was no great impact on the general fiscal situation due to high food prices.

111. (U) High food prices could fuel agricultural growth, if markets are allowed to operate freely. Unfortunately, the government has

stepped in to control prices of rice and other staples, preventing farmers from realizing the benefits of high prices. Approximately 30 percent of the population -- those involved in agricultural production -- could benefit from high prices if market forces were allowed to determine prices.

¶112. (U) Department of Census and Statistics figures show that rice prices have increased 102 percent from April 2007 to April 2008. Similarly, price of wheat flour and bread have increased by 71 percent and 55 percent, respectively, during the same period. Around 50 percent of households live on less than \$150 a month and are thus severely affected by high prices. According to Dr. Harsha De Silva, a leading local economist, food security is a serious concern and poverty in Sri Lanka will increase further due to rising prices. Some economic analysts cite reduced nutrition levels of the poor in asserting that rising food prices in 2007/2008 may be depriving a significant portion of the population of both rice and wheat.

Environmental Impact

¶113. (U) There is no evident environmental impact stemming from rising food prices.

Government Policy Response

¶114. (U) The government implemented several measures in response to high prices. It withdrew a 20 percent import tariff on rice in March. In April, the government established retail price ceilings on rice, angering rice millers, traders and farmers. The government also continues to maintain price controls on chicken, wheat flour and milk powder. For other commodities, high prices are allowed to be passed on to consumers. The government continues to subsidize about 85% of the cost of fertilizer for small farmers -- a subsidy provided before the recent hikes in agricultural prices. Though farmers frequently sell the subsidized fertilizer at market prices rather than apply to crops.

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¶115. (SBU) Dr. De Silva emphasized that government has to curtail expenditure and impose tight fiscal controls in order to reduce inflation. He asserts poor fiscal policy is largely to blame for the current rate of high inflation. To combat inflation expectations, the Central Bank announced in its 2007 annual report that it would attempt to meet strict monetary policy targets to reduce inflation. The Central Bank also recommended that the government follow a "prudent and sustainable" fiscal management strategy to achieve low inflation in the medium to long term. However, the government, which has a history of ignoring sound economic advice from its own Central Bank, is unlikely to be able to reduce its fiscal deficit enough to significantly bring down inflation.

Impact on Post Programs

¶116. (U) To date there has been no impact on post's programs.

Policy Proposals

¶117. (U) The government needs to make a number of policy decisions to reverse food commodity inflation. In agriculture, encouragement of increased private sector investment, a gradual phase-out of the fertilizer subsidy, development of marketing infrastructure including increased access and direct links to markets, discontinuation of government intervention in markets, introduction of new technologies, and modernized agriculture practices are some of the key areas that need consideration.

¶18. (U) For the USG, it is recommended that all agencies dealing in food aid-funded agriculture development direct resources into public-private partnerships. Private sector involvement in projects secures markets for farmers, provides sustainability due to the commercial aspect involved, and demonstrates the viability of farming as a sustainable income generating activity for rural youth.

BLAKE